www.rasabourse.com

CHAPTER 12

Becoming a Trader

Intention, good or bad, is not enough.

—John Steinbeck

Most of this book applies equally well to individual or institutional traders across a wide range of time frames and asset classes. The lessons of statistical tendencies and market structure are universal; ideas regarding trade and risk management are important for everyone, and can even be adapted to work in conjunction with Modern Portfolio Theory (MPT) in some applications. This chapter is different; it is written specifically for the individual self-directed trader trying to manage all of the complex tasks of trading on his or her own. The rest of the book has given you many of the pieces you need to be successful. Without a firm understanding of all of those pieces, you are not likely to be successful in the long run, but even if you are able to master the individual parts, success may still be elusive. Putting it all together into a coherent whole, building a trading methodology that fits your personality, and living through the learning curve make up a monumental challenge.

This chapter also is intended to be a reality check. If there is one message for new traders to take away from this book, it is this: trading is hard—very hard. It will challenge you in ways that you cannot imagine, and it will take much longer than you expect to reach a level of competence. Your success will be incremental and ephemeral at first. Expect an emotional roller coaster where progress is followed by errors and failures that erase most of that progress in the next period. Remember that most people who try to trade will fail, or trading will remain a marginal hobby that has no real financial impact on their net worth. If you are determined to make it something more, you have a long, hard journey ahead, and you must be prepared.

www.rasabourse.com

THE PROCESS

The challenges of becoming a trader are similar in many ways to those faced by doctors, lawyers, or engineers in that a period of education is followed by a grueling period of apprenticeship and on-the-job training. Many people give up and fail at some point in the process and move to other careers, but some make it through and become competent. Fewer still achieve real mastery and rise to the top of their profession—the elite in any discipline are rare. Trading differs from those careers in that the path to mastery is not as clearly laid out, and there are no prizes for second best. In many professions, people can develop the skills to become competent but not exceptional and can make a good living. In trading, especially for the individual trader, only the superstars make substantial profits over a long period of time.

In the interest of moderating expectations, it might be useful to lay out a rough road map of the typical path of trader development. In some ways, this is an artificial exercise because individual traders will have dramatically different experiences at some points due to differences in environment, innate ability, mentoring, or pure luck. Traders' development will also depend, to a large degree, on the specific market environment in which they begin their education—some years are more challenging than others. However, the following stages are a useful guide:

- *Pretrader*. Everything is new at this stage, and everything is difficult. This is the point where the trader is learning the very basics of charting and of market structure and is also just starting to explore the marketplace. A trader at this stage has no business actually placing trades, because the emotional charge will hinder the learning process, and losses are virtually assured. Most traders should probably spend three months or so in this stage. *Papertrading* (trading a simulated, not real money, account) has limited utility, but it can be useful at this stage to acclimate the trader to the process of making decisions under uncertainty and in response to market movements.
- *Novice trader*. This trader is still guaranteed to lose, so his maxim must be "Stay small." At this stage, traders are not trading to make money; they are trading for experience and to begin to deal with the emotional challenges of trading. Introspection and constant journaling are critical in this stage of development, which may last six months to a full year. Mistakes are common in this stage, but they are also learning opportunities, so trade size must be kept small enough that they are not too destructive to trading capital or emotional balance. If the trader neglects the process of journaling and trade review, these mistakes simply become losses and fall short of being the learning experiences they should be. One of the main signs of progress in this stage is that the trader will start to lose money more slowly than before. The novice trader is still losing, but losing less often and less consistently.
- *Early competent trader*. The first step toward making money is to stop losing money. A trader whose wins and losses balance out (before commissions) has taken the first

www.rasabourse.com

steps to competence. Reaching this stage may take a year or more of very hard work. At this stage, the trader is still losing money every month due to transaction costs and other fees.

- *Competent trader*. The first stage of real competence is achieved when the trader is able to cover transaction costs with trading profits. Most traders find that they begin to develop emotional balance and control at this stage, and that they are not too attached to results and can focus more on the process. The trader will have an established routine for market review, execution, and trade review. Journaling is still important, but many of the psychological hurdles have been conquered and attention can shift to understanding how probabilities change while a trade is in progress. Reaching this stage may take a year and a half to two years for some traders. Consider this carefully—two years into the journey, a realistic expectation is to finally have accomplished the goal of being able to pay for your transaction costs. This may not seem like much, but very few individual traders ever survive to this stage.
- *Proficient trader*. Here the trader starts making money. Errors and mistakes are far less frequent, but when they do happen, they are corrected and reviewed, and the lessons are quickly assimilated. The trader has been exposed to the stressors of trading so many times that they have now lost most of their emotional charge and the trader is able to approach the markets in an open, receptive state. Trading returns are still variable and there may be significant losing periods, but the trader is able to match or beat appropriate benchmarks for most periods. As competence grows, the trader can look to manage larger and larger pools of money; developing the skills of trading larger size and risk becomes a focus at this stage. Most individual traders will be able to depend on income from their trading operation at some point in this stage, provided that they have access to sufficient capital. Expect that getting here may well take three to five years for the average trader.
- *Experienced trader*. It is difficult to imagine a trader becoming a true veteran without living through a complete bull/bear market cycle—about a decade in most cases. This trader has finally seen it all and has also become cognizant of the unknown and unknowable risks that accompany all market activity. It is possible for developing traders to gain much of this veteran trader's *knowledge* through study at earlier stages of development, but there is no substitute for experience and seeing events unfold in the market in real time. Even this experienced trader is not immune to losing periods. For instance, it is not uncommon for very proficient traders to stumble in the presence of an outside influence such as illness or family issues, but these traders usually have the control to know when to scale back their operations to limit the damage.

Requirements

With this rough road map in hand, we can next consider the prerequisites and necessities of trading. On one hand, the requirements seem to be minimal: anyone with a few thousand dollars and an Internet connection can open an account and place trades, but this

www.rasabourse.com

does not mean that you can compete effectively, anymore than buying a football qualifies you to be in the NFL. Just because you have access to a market and can execute effectively does not mean that you can profit in an environment that immediately punishes any errors or inaccuracies. Many traders who fail do so because they have unrealistic expectations about what it takes to be a trader, and these misconceptions are reinforced by many authors and gurus. What follows is a brief but brutally realistic assessment of the basic requirements a beginning trader needs in order to have a chance of competing successfully in the marketplace.

Time Time is important in at least two different meanings. First, you must be able to devote a sufficient amount of time on a regular schedule to building trading knowledge and skills. Within reason, the more time you can devote to the task, the quicker you will grow. It is important that you have a regular schedule for reviewing current market action and potential trades, and also important to have a time to review your own trades and your performance. It is better to have many repeated, regular work sessions than to work one marathon session infrequently. For instance, most developing traders will find that a half hour a day, every day, is more rewarding than a single 12-hour session on the weekend. Remember, part of the reason for the length of the learning curve is that you are physically restructuring your brain; this process works most efficiently in the presence of repeated and constant stimuli.

These physical changes in the brain also take time, and it is important to be realistic about the amount of time required for the entire learning curve. Most traders are unlikely to find any degree of enduring success in less than three years—a three- to four-year time horizon is consistent with what is required to achieve some degree of mastery in most other fields. It does sometimes happen that new traders start in exactly the right environments and have quick success, but this is probably the worst thing that can happen to a new trader. Many traders made quick and easy profits in the dot-com bubble in the late 1990s, as did those who began their trading adventures during the 2007 to 2008 financial crisis and crude oil bubble. Very few traders who begin in an easy environment like this have long and successful careers. When markets revert to more normal conditions, they are not able to adapt to the slower pace and to a trading environment that requires real skill and discipline.

You should be prepared to endure three years of trading with very limited success, especially if you are gauging success by the bottom-line profit and loss (P&L). It is entirely possible that the majority of your trading experiences in this period will consist of booking constant losses, but this is a normal part of the development process. You will have triumphs, breakthroughs, and successes, but do not expect to be profitable; no trader should make a call on his or her long-term ability in those first three years of trading. If you find you do not love trading as much as you expected, then consider it an important lesson learned and move on to something that does give you joy. On the other hand, if you find yourself captivated by the process but are frustrated by your lack of trading ability, persevere.

www.rasabourse.com

Capital It certainly *is* possible to trade for a living or to trade as a career, but there are significant constraints that must be considered. Most people do not have realistic expectations about the returns that professional traders make, so many of these traders believe they will be able to support their lifestyle with $100,000 (or less) of risk capital. At the institutional level, traders who can consistently make a 25 percent return on capital each year are very rare; these are the rock stars in the industry. Many competent traders are able to, at best, beat their benchmarks by a few percentage points; if you can do so by even a few *basis points* consistently, you can have a very successful career as a money manager. It is unrealistic to expect to consistently return hundreds of percents a year on your capital; it may happen in some extraordinary years, but this is not a realistic long-term plan. Do not go into this business as an individual trader expecting to dramatically outperform the industry benchmarks.

It is also necessary for the developing trader to have a sufficient amount of risk capital to fund the learning curve. You will lose money while you are learning to trade. Make no mistake about it—*plan* to lose money. Too many traders start off with very small (less than $25,000) accounts and plan not only to be profitable but to pay living expenses out of that account very quickly. This is unrealistic and is a formula that virtually assures failure. Plan for additional funds for educational expenses, books, and possibly even some graduate-level coursework, depending on your interests and educational background.

Working in a Team Many of the best professional traders work in a team, and some of them count it as an essential part of their success. For this to be most effective, the team must actually share both trading decisions and P&L; though is it scary, the reason this arrangement works is that your decisions will have an impact on someone else's P&L and vice versa. Traders working in this arrangement are essentially yoked together—they will succeed or fail *together*. There are many advantages to this arrangement, but the most significant of them deal with the issues of discipline and self-control. It is much more difficult to do something reckless or stupid if you know that not only will you have to be accountable to another person, but your mistake will actually cost that person money. Teammates who work together closely develop a sense of each other's rhythm, strengths, and weaknesses, so it is often easy to address behavioral problems before they have an impact on the P&L. In addition, there are obvious advantages of having two sets of eyes on trading questions and market data, and the camaraderie of a trusted teammate can counteract the isolation of trading.

This is not a relationship to be entered into lightly or halfway. It is important that you know and trust the other person, because you will be giving that individual full access to your trading capital. Firm, written contracts are also essential, outlining responsibilities and obligations for both parties. It is also worth considering that this arrangement is problematic for developing traders and may be much more suitable for established, consistent traders. Having another person in the decision process can compound the already severe emotional challenges developing traders face. In addition, two developing traders will grow at different rates and will have different sets of strengths and weaknesses.

www.rasabourse.com

There is great potential for reinforcement of weaknesses and additional confirmation bias if developing traders work too closely in teams.

It is possible to work an arrangement like this at a distance, though there are many advantages to working in the same office. If you decide to pursue this relationship, spend a lot of time considering how you will work with your teammate. Expectations must be clearly defined. Have a clear plan for how work will be divided; it makes sense to do some of the work together, but most teams find it useful to have done a good deal of individual work before bringing ideas to the team. Expect that you both will make errors, and expect to be called out on them. One of the reasons you are working with another person is to have the benefit of someone looking over your shoulder and monitoring your emotional state, but the first time you are on tilt and someone taps you on the shoulder to suggest that you need to step back is always a difficult moment in the life of a trader. It requires exceptional maturity and self-awareness to successfully manage a teammate relationship in the emotionally charged trading environment, but the benefits can be substantial. This element of teamwork is a secret of top-level professional trading that is not often available to the at-home individual trader.

Working with a Mentor Most traders who achieve some degree of success owe much of that success to the guidance of a mentor. (Personally, I can think of three people without whom I probably would not have succeeded in this business.) There are many ways this relationship can work, ranging from one-on-one instruction over an extended period of time to much less frequent course corrections. In addition, a mentor can guide a new trader in many different ways. Some mentors are teachers who prefer to work with students who have little or no market knowledge, starting at the beginning and building a comprehensive approach to trading. Others may work more as coaches, preferring to take a student's system and knowledge and help to shape the application of that system.

There are at least three important issues to consider about the mentoring relationship. First, both parties must be committed and there must be a clear understanding of responsibilities and obligations. An effective mentor does not have to spend long hours with a student, but if the student expects that kind of time and the mentor does not, the relationship will not be successful. If a mentor expects to work only with full-time, professional traders, then a student working very hard to learn on evenings and weekends is probably not going to fulfill expectations.

Second, the question of fit is very important, both in style and personality. A mentor with a hard-core, drill-sergeant style approach will be completely ineffective with a student seeking a supportive, nurturing approach. A mentor who focuses on intraday trading will probably be less effective working with students who focus on longer-term trades—there certainly can be exceptions to these rules, but the issue of fit is paramount.

Last, the issue of compensation should be understood clearly by both parties. Mentoring can be a major investment of time and energy from the mentor's side, so it is reasonable for that person to be paid for the time, but too many mentors are not competent traders themselves. Anyone can claim to offer trader mentoring, but it is difficult for the student to truly evaluate the mentor's skill and ability.

www.rasabourse.com

Technology: Software and Hardware It goes without saying that you must have access to good infrastructure: On the hardware side, you must have one or more good computers with data backup and fast, reliable Internet access. In terms of software, you need a few important tools:

- *Execution software:* Many traders base their choice of broker on the quality of its execution software. It should be easy to use, allow easy tracking of positions and open orders, and have excellent accounting support. Most traders find that it is a good trade-off to pay slightly higher commissions for better software and accounting—many of the lowest-cost brokers do not offer acceptable software interfaces, though this gap has closed in recent years.
- *Charting software:* Most execution packages incorporate some degree of charting capability, but many traders find it worthwhile to pay for specialized charting programs. Good charting software has fast access to data, all of the relevant data for markets you trade, and the ability to customize displays to fit your preferences. Most higher-level programs will allow you to write programs for custom indicators and customized data processing; some traders find this to be a valuable capability. Last, if you trade futures, make sure you understand how your vendor handles rolls and continuous contracts.
- *Record-keeping software:* There are several ways to keep the records you need, and each trader must develop his or her own system. Some will prefer to keep journals and trade records in a word processing document, while others will prefer more complex solutions like a database.
- *Microsoft Excel:* This deserves its own bullet point since nearly every trader will use it in some way. Invest the time learning to use it well and properly: be comfortable with formulas, references, and macros, and learn to use it without touching the mouse. (Keyboard shortcuts are literally five times faster than corresponding operations with the mouse.) Excel is adequate for many basic analytical and record-keeping tasks.
- *Analytical software:* If you intend to perform deeper analysis of market tendencies and create your own statistical studies, you will need to move beyond Excel at some point. Excel is capable of doing some fairly in-depth analyses, but it is not the right tool for this job. Some versions of Excel have small but persistent calculation errors that can cause serious errors in trading applications, and Excel's management of large data sets is cumbersome at best. Though it is a major commitment of both time and money, learning to use a software package like SPSS, SAS, Stata, or R is the only alternative for traders wanting to do their own deep-dive data analysis.

A Business Plan and Trading Plan Always think of your trading as a business and treat it as such. No one would try to start a business with insufficient capital, with no plan for how to expand the business, and with no vision of where the business could be in one, five, or 10 years, but this is exactly how most people start trading. The challenge,

www.rasabourse.com

of course, is that you do not know at the beginning if you will be able to develop the skills to trade successfully, or how long it will take. There are many more uncertainties than in most other areas of business, but there are parallels—imagine a company that is making a speculative bet on a new product that may or may not catch on, or a new industrial process that may or may not be able to take market share from existing competitors. In these cases, the companies would make very sure that they understood the competitive marketplace, that they had access to resources they need to succeed, and that they had sufficient capital to weather the start-up period, though their long-term success might be less than certain.

With this in mind, craft a business plan for your trading operations. This will be a plan that, hopefully, will mature as your trading abilities develop. In the beginning, perhaps this is a document that focuses on your development and provides a yardstick for measuring your commitment. As you actually start trading, the document can be modified to encompass risk parameters, markets traded, and new directions you are exploring. (Strike a balance between modifying this document often enough that it is relevant and having a good control document. If the plan is always changing, it is probably not very helpful.) Hopefully, at some point you will expand this plan and perhaps even use it to recruit partners or investors as your trading business grows. The sky truly is the limit, but you must approach this as an extremely competitive and difficult business.

While the business plan is the overarching control document, the trading plan is more dynamic and flexible. The trading plan defines exactly what you will and will not do in the market, and it will evolve as your trading abilities mature. It is not unusual to revise a trading plan at least slightly every month; each trader will adapt the concept of a trading plan slightly, but a good plan will include all of the following:

- Schedule for your daily or weekly research and trade review.
- List of patterns and ideas you will trade, similar to Chapter 6.
- Target activity and risk levels. How many trades a day/week/month will you allow? How many positions can you have on at the same time? What is the maximum percentage of your capital that can be at risk at any time? How and when will you use margin? Is there a loss level at which you will stop trading for the day/week/month?
- A clear plan for trade management. Will you enter all at once or scale in? Will you take partial profits? If so, where and how?
- How often will you make trading decisions? Are you able to make decisions in the middle of the day, or do you prefer to create a plan the night before and simply execute it as faithfully as possible during the trading day?

Once you have these documents, much of your work boils down to making sure that you are following the plan. Remember, any evaluation of your performance over any time period is an evaluation of both your plan and how well you followed that plan. Follow the plan as precisely as possible to remove extraneous sources of variation in your returns.

www.rasabourse.com

Commit to the Process

In many ways, the intellectual problems of trading are trivial. This may seem to be an ironic statement, given that it appears in a large book about trading, but the essential elements of market structure and trade management could fit on a single piece of paper. The elaborations, variations, and applications are much more extensive and will reward long study, but the core knowledge of trading is not complicated. Most traders rather quickly assimilate the foundation, but the gap between knowledge and execution must be bridged. The core *skills* of competent trading—and be clear that skill is not the same as knowledge—are primarily emotional. If traders have not mastered discipline and emotional poise in the face of volatile market movements, their trading will be forever plagued by errors that will erode whatever edge they may have had. Though it is possible to accelerate the learning curve in many areas, the only way to master emotional control is through actual trading over an extended period of time. The process of trading can be summarized as doing analysis, making decisions, putting capital at risk, and dealing with the consequences. Only by living through that loop repeatedly can the trader make progress; regular, repeated exposure is the key.

Stay Small Again, while you are going through this learning curve, *expect to lose money*. This is what new and developing traders do—they lose money while they are learning. Therefore, it makes sense to keep your risk as small as possible on each trade until you have achieved consistency. The gain or loss on any individual trade should be so small that it is insignificant; the point of early trading is to gain experience and to learn about the trading process while keeping the losses as small as possible.

Granularity is an issue in some markets. For instance, equity and forex traders can usually trade small enough that they can risk a tiny amount, say $50, per trade. A trader who has a $25,000 to $50,000 trading account can lose $50 many times in a row before he has made a dent in his allocated capital. Futures and options traders, in contrast, may often find it difficult to risk less than $500 on a trade because of the size of the contracts. From a purely technical perspective, there are reasons why forex may be very difficult for shorter-term traders, but equities might offer a better learning environment than either futures or options for newer traders. This point cannot be overemphasized: keep your risk small enough that the win or loss on any individual trade is insignificant until you have shown many months of consistent profitability.

Periodic Evaluations It is important to have a regularly scheduled time to evaluate your trading performance, both over the most recent period and over a longer time span. This would also be an appropriate time to check in with a more experienced trader, a coach, or a mentor if you do not work with someone on a regular basis. For most traders, the end of the month is a natural spot, but for other, longer-term traders, the end of the quarter might be more suitable. Find a balance between having frequent enough reviews to make useful corrections and having long enough periods of trading in between so that

www.rasabourse.com

performance trends are meaningful. (Even for active traders, a week is too short a time for a serious reevaluation.)

This review does not have to be a complicated, painful process, but it must be done regularly. At a minimum, review your equity curve (perhaps without commissions for the developing trader), the performance of the various categories of trades you are trading, and each individual trade made over the period. It may also make sense to review psychological journals and performance, and most importantly, to note any recurring errors. The result of this periodic evaluation should be a written list of things to work on in the next period. This does not have to be a long list; in fact, many times it will be useful to identify only the two or three biggest issues the trader is facing. Note that there is an obvious tie-in with the quality of your record keeping and the ease with which this review can be done. If your records are a mess, then this review will be much less effective.

Dealing with Setbacks If you are an individual self-directed trader, expect setbacks and failures, especially in the first two years. Expect that your triumphs may be promptly followed by dramatic failures, that you will make mistakes in areas you thought you had mastered, and that any positive P&L may be quickly erased next week. Furthermore, do not expect that your learning curve will be described by a straight, upward-sloping line. It is far more common for students of any high-level skill to find that their progress comes in a series of jumps interspersed with long, flat plateaus. It is often difficult to maintain motivation during the flat periods, because you will feel that you are working very hard and not making any progress, and then progress comes, seemingly overnight, in a blinding flash. The reason for the sudden spurts of progress is the hard work done on the plateaus, but it can be difficult to keep up very hard work for seemingly no reward.

You will hear various stats suggesting that somewhere around 95 percent of self-directed traders fail. The definition of failure, of course, depends on your definition of success. What is success in the market? Is it being able to make a living, pay your bills, and have enough left over for security? Is it having the satisfaction of being able to do something extremely difficult well, so that being able to manage the trading process is itself a degree of success? Is it as simple as beating the indexes by a few percentage points, consistently outperforming what a professional investment manager would be able to do for your account? Your definition of success will probably change as your trading ability matures and your personal financial goals shift, but trading success must be both financial and nonfinancial. Be clear that trading is about making money—whatever other motivations and satisfactions are tied into the process, at the end of the day there must be financial reward and it must be substantial. Trading is difficult, time-consuming, and emotionally challenging, and nearly all traders find that their trading income is highly variable, so a higher average (annual) income is required relative to other professions. However, it will be very difficult to succeed if you are not absolutely fascinated by markets and the process of trading. If you don't love it, you won't be a very good trader, so there must be motivations for trading that go beyond financial gain.

If we redefine success as making substantial financial gains on a percentage basis, then I suspect the success rate for individual traders is far less than 5 percent. In fact,

www.rasabourse.com

probably fewer than one in a thousand, and maybe *many* fewer than that, really succeeds. If you are going to be in this elite group, you must prepare yourself, work hard, and have the emotional resilience to deal with setbacks along the way. It is very hard to find common personality traits that make people suited to be traders; most people can succeed in some capacity if they find a market and trading style that fits their personality, if they have realistic expectations and all of the prerequisites for success, and if they commit to enduring the learning curve.

One last thought on this subject: When we look at people who are very successful in any field, we find a very mixed group. They come from different backgrounds, have very different personalities and attitudes, and reached their success through interesting paths, some of which are far from straight. In most fields, it is impossible to find consistent predictors of success, but people who succeed have one thing in common—they did not quit. This is so simple that it seems trivial, but *is* the common thread tying all of these people together. As Mark Cuban said, “It doesn’t matter how many times you fail. It doesn’t matter how many times you almost get it right. No one is going to know or care about your failures, and neither should you. All you have to do is learn from them and those around you because . . . all that matters . . . is that you get it right once. Then everyone can tell you how lucky you are.” Commit to the process. Never give up.

RECORD KEEPING

Good record keeping is an important part of skill development in many disciplines. Self-directed traders usually focus on two specific kinds of records: trading journals and trade-specific records. Trading journals may include narrative about the patterns in the markets and pattern research, or they may focus on psychological issues the trader is struggling with. Trade-specific records are P&L records with some deeper information on each trade: at least the type of trade and initial risk assumed on the position. If these records are done well, it is then possible to do deep performance analysis on them to understand how the trader’s ability is growing and to target specific areas for further work.

There are many ways to create and format these sets of records once you understand the goals. With all of these records, the most important thing is to create a routine that you can commit to following on a regular schedule. There is a trade-off between complexity and ease of use; it does no good to create an elaborate system that takes so much time to maintain that you do not do it on a regular basis. On the other hand, an overly simplistic record will probably not contain enough information to be useful. Invest time at the beginning planning and creating a system that will work for you, be open to some revision as you use it, and once you have settled on a final plan, commit to keeping these records consistently. It is not unusual for traders to spend more time maintaining and reviewing these records than they do in actual trading.

Another issue to consider is whether the records will be kept on paper, in an electronic format, or in some combination of the two. Electronic records have many advantages, probably the most important of which is that they are easily searchable. If you want